

Japan's Virtual Currency Regulation and its Recent Developments

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Revised Payment Services Act introducing virtual currency regime to Japan's financial industry took effect on April 1, 2017.

<Key events affecting legislation>

February 28, 2014	MTGOX filed for bankruptcy rehabilitation with Tokyo District Court
March 7, 2014	Cabinet answer for questions about legal issues of Bitcoin
March 18, 2014	Cabinet second answer for questions about legal issues of Bitcoin
June 19, 2014	Liberal Democratic Party IT Strategic Committee (Payment Subcommittee) "Interim report on 'Digital Assets' like Bitcoin"
June 8, 2015	Leaders' Declaration G7 Summit at Schloss Elmau
June 28, 2015	FATF "Guidance for a Risk-based approach to virtual currency"
January 2016	IMF "Virtual Currency and Beyond"
February 8, 2016	FSA 24 th Financial Subcommittee "Working group report on enhancing Japan's payment business"
March 4, 2016	"Banking laws reform act responding to environmental changes in information technology space" submitted to the House of Representatives
May 25, 2016	Bill passed
April 1, 2017	Revised Payment Services Act took effect
July 1, 2017	Revised enforcement order regarding consumption tax code took effect.
September 2017	11 exchanges got registered as Virtual Currency Exchange Service Provider
October 27, 2017	ICO warning issued by FSA
December 9, 2017	ICO guidance from JCBA

Understanding past official views is vital to understand VC regulation

Government's official views on virtual currency so far

- a series of the Government's official views have provided basis of legal status/treatment of virtual currencies
- past views are still important because these views will not change unless stamped by subsequent official views or new legislation

◆ Nature of virtual currency

- **"Bitcoin is NOT a currency"**

Civil Act of Japan, Sections 402.1 and 402.2 context :

"currency" means coins with mandated liquidity and bank of japan notes in which the payment is valid per-se

- Bitcoin is not a currency because it does not have a mandated liquidity or the payment is only valid if agreed by persons involved

Foreign Exchange Law, Section 6.1 context:

"currency" means bank notes with mandated liquidity, governmental bill or coins

- Bitcoin is not a currency because it does not have a mandated liquidity or not a bank note or issued by government

"Japanese currency" means the currency denominated in Japanese yen

- Bitcoin is not a Japanese currency because it is not denominated in Japanese yen

"Foreign currency" means any currency other than Japanese currency.

- Bitcoin is not a foreign currency because it is not a currency.

◆ Core banking business

- **"Handling of Bitcoins does NOT fall into the 'banking business' under Banking Act of Japan"**

<What does this mean?>

- Handling or dealing with virtual currency is not a bank's core business as handling and dealing with currency is a bank's core business
- Handling of Bitcoins does not require banking license
 - Section 2.2 of the Banking Act of Japan presumes money as "currency"

Understanding past official views is vital to understand VC regulation

◆ Securities trading

- **“Trading of Bitcoins does NOT fall into the “trading of securities”** under the Financial Instruments and Exchange Act of Japan”

<What does this mean?>

- Bitcoin trading is not subject to securities regulations
- Handling of Bitcoins does not require licenses under FIEA
 - FIEA is applicable only to the securities and any other rights in which dividends are paid or revenues are shared

◆ Use of virtual currency

- **“Japanese legal system does not prohibit persons from using Bitcoins for commerce”**

<What does this mean?>

- There is no legislation that prohibits persons from using virtual currency as a means of payment.
- People can use virtual currencies for payment of goods and services etc.

◆ Taxation

- **“Bitcoin is subject to tax under relevant tax codes”**

<What does this mean?>

- You will be taxed under Income Tax Code of Japan if an individual gains earnings in the form of virtual currency
- You will be taxed under Corporate Tax Code of Japan if a corporation gains earnings in the form of virtual currency
- Purchasing virtual currency is subject to consumption tax under the Consumption Tax Code → *Revised*

Understanding past official views is vital to understand VC regulation

◆ Bank's scope of business

- "In principle, Banks may not deal with Bitcoins"

Intermediary activities regarding sale and purchase of Bitcoins, exchanging Bitcoins with Japanese currency or foreign currency, opening account to deposit Bitcoins, transferring Bitcoins from one account to another account are NOT the businesses that banks are permitted to operate under each sub-paragraph of Section 10.1, each sub-paragraph of Section 10.2 and each sub-paragraph of Section 11 of Banking Act of Japan.

<What does this mean?>

- Under Japanese banking regulation, the scope of business with banks are limited to those enumerated in the Banking Act. There is only one open-ended exception to this, where a bank may engage in businesses that are peripheral to its current business (Banking Act, main paragraph of Section 10.1).
 - Whether or not a specific business is peripheral is determined by four factors: (i) whether such business is akin to the businesses set out in each sub-paragraph of Section 10.1 or sub-paragraph of Section 10.2; (ii) whether the size of such business is excessively large as compared to its main business; (iii) whether such business has a similarity to the banking business in terms of its function or risk profile; (iv) whether such business helps a bank utilize its surplus capacity.
 - A Bank might be able to handle virtual currencies only if it can show the following four factors based on its current business circumstances.
 - Since this limitation comes from a restriction on bank's scope of business, banks may touch virtual currencies to the extent that it is not deemed as "business"
- 5% rule is applicable to a bank's investment in virtual currency businesses
- The current regulation probably does not allow a bank to acquire a virtual currency exchange company, but a new banking law reform act might enable a bank to make a virtual currency exchange company a subsidiary upon FSA's approval (sub-paragraph 12-3, Section 16-2.1 of revised Banking Act).
- Bank's investment in financial products that incorporate Bitcoins (i.e., investment trust holding Bitcoins as one of its portfolio assets, or a derivative products referring to Bitcoins) is currently not explicitly prohibited.

Understanding past official views is vital to understand VC regulation

◆ Asset manager and broker/dealer's scope of business

- "Type I Financial Instruments Business Operators (broker/dealer) and licensed asset managers are allowed to engage in asset management business that involves VCs (FIEA, Sections 35.2.6 and 35.2.7, Cabinet Order regarding Financial Instruments Exchange Business, sub-paragraph 19, Section 68).
- Financial Instruments Exchange Business Operators may engage in derivative transactions referring to VCs upon approval of authority.

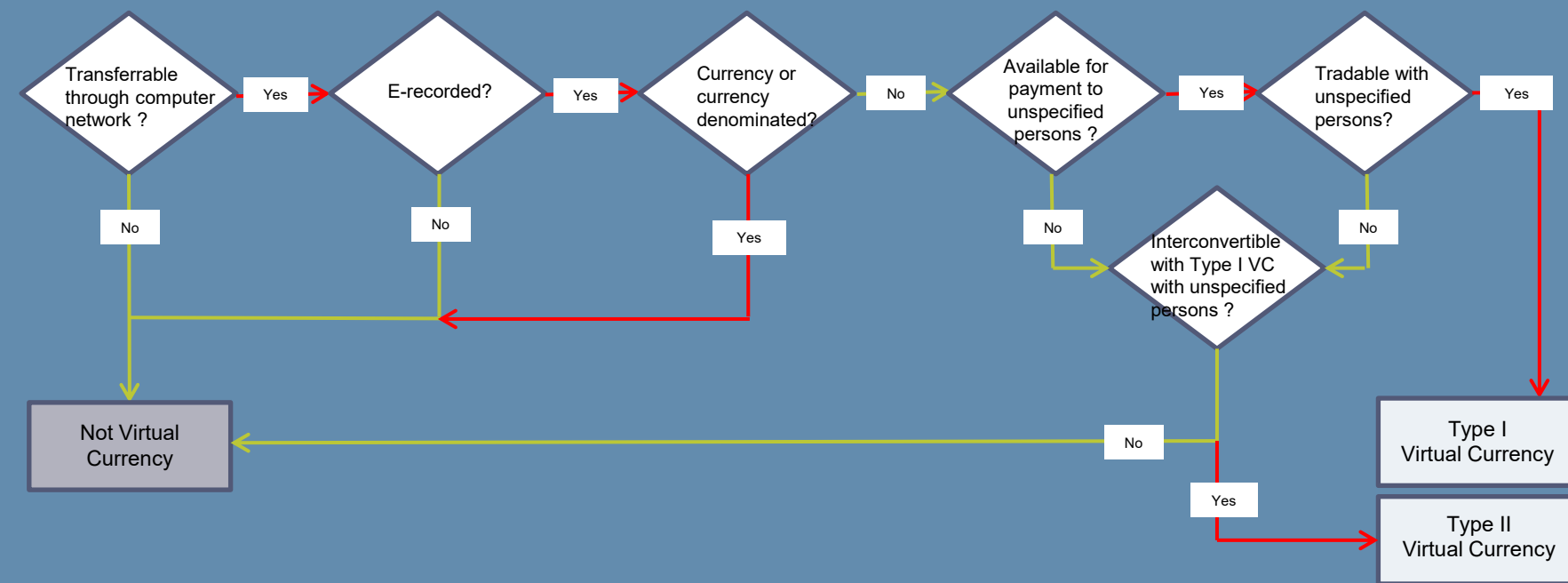
◆ Foreign Exchange and Foreign Trade Control Law

- Export control (Forex Law, Section 10 and Section 48.3) is applicable to any export, such that export of goods subject to export control in exchange for VCs without prior permission is a violation of law.
- A Japanese resident is required to submit a report to the relevant authorities if he transfers VC above a threshold amount (E.g. JPY30MM) as a means of payment.

Virtual Currency definitions are divided into two under revised PSA

- Type I Virtual Currency:** Proprietary value (i) **available for a means of payment against unspecified persons** in exchange for purchasing or borrowing goods or receiving services AND (ii) that is able to be **exchanged with fiat currency against unspecified persons** (limited to that recorded on an electric device or other materials in an electronic manner and excluding Japanese or foreign currencies or currency denominated assets), AND (iii) that is transferrable through a computer network; or
- Type II Virtual Currency:** Proprietary value that is **mutually exchangeable with Type I Virtual Currency against unspecified persons**, AND that is transferrable through a computer network.

<Virtual Currency Flowchart>



Virtual Currency Exchange Business is broadly defined to include various intermediary activities

<Virtual Currency Exchange Business>

Any of the following activities carries out as a business:

- (1) Sale/purchase of VCs OR exchange for other VCs
- (2) Intermediary, agency or brokerage activities for (1)
- (3) Management of users' money or VCs in conjunction with (1) or (2)

<Notes>

- (1) Registration required for VC exchanges
- (2) Registration required for other intermediary activities
 - E.g. Soliciting a purchase of VCs to general public → MLM model extremely difficult
 - Service providers being outsourced from registered service provider do not need registration (Section 63-9)
- (3) Registration required for management of funds or VCs in conjunction with (1) or (2)
 - **Registration not required for a mere wallet provider** because it does not provide wallet "in connection with" VC trading/intermediary activities
 - Registration required for wallet providers acting as "middleman" for VC trading

<Issues>

- Sale of VCs at ATMs requires registration, but may be outsourced without registration from registered service providers
- Proprietary trading by traders is not subject to registration
- EC merchants accepts Bitcoins are not subject to registration
- Token sales might need a registration.

Anti-money laundering regulations and minimum consumer protection rules have been installed

<AML/CFT rules>

- ◆ VC Exchange Service provider to be added as “designated service provider” under Act on Prevention of Transfer of Criminal Proceeds (APTCP) and subject to following obligations:
 - KYC process in opening an account
 - Preparation and maintenance of books and records
 - Filing of suspicious activity report
 - Internal control system (internal rules, training, appointment of manager etc.)
- ◆ Using others’ ID in VC trading is a crime (felony equivalent if engaged as business)

<Consumer protection>

Low-key regulation due to (i) low VC penetration to general public and (ii) nurture of startups

- ◆ **Prudential standard**
 - **Minimum capitalization JPY 10M**; Qualitative financial standard necessary to carry on the business properly
 - Submission of **auditing report by external auditor**
- ◆ **Disclosure; transparency**
 - Explaining users about selling VCs (E.g. VC is not a currency so that it is not guaranteed for conversion into currency, risked involved with the VCs)
 - Information provision (details of transaction, transaction charges, ADR information etc.)
 - Provision of written documents upon transaction
- ◆ **Conduct of business rules**
 - Notification to authority upon change in registered items
 - Registered provider may not let a third party use its name and engage in VC exchange business
- ◆ **Organizational and operational standards**
 - Information security management
 - Management of outsourcee
 - Internal control system (internal rules, training, appointment of manager etc.)
 - Personal data protection measures

Co-regulation framework attempting to strike a best balance between consumer protection and encouragement of innovation

Consumer protection (cont.)

- ◆ **Segregation of assets**
 - Clients' assets to be managed separately from own assets
 - Annual audit by external auditor as to appropriateness of the separation
- ◆ **Books and records**
 - Preparation and maintenance of books and records
 - Submission of annual report to authority
- ◆ **Monitoring by authority**
 - VC exchange business providers to be monitored by local finance bureau
 - Reporting in case of mismanagement
 - Inspection, corrective order, suspension of business, and revocation of license

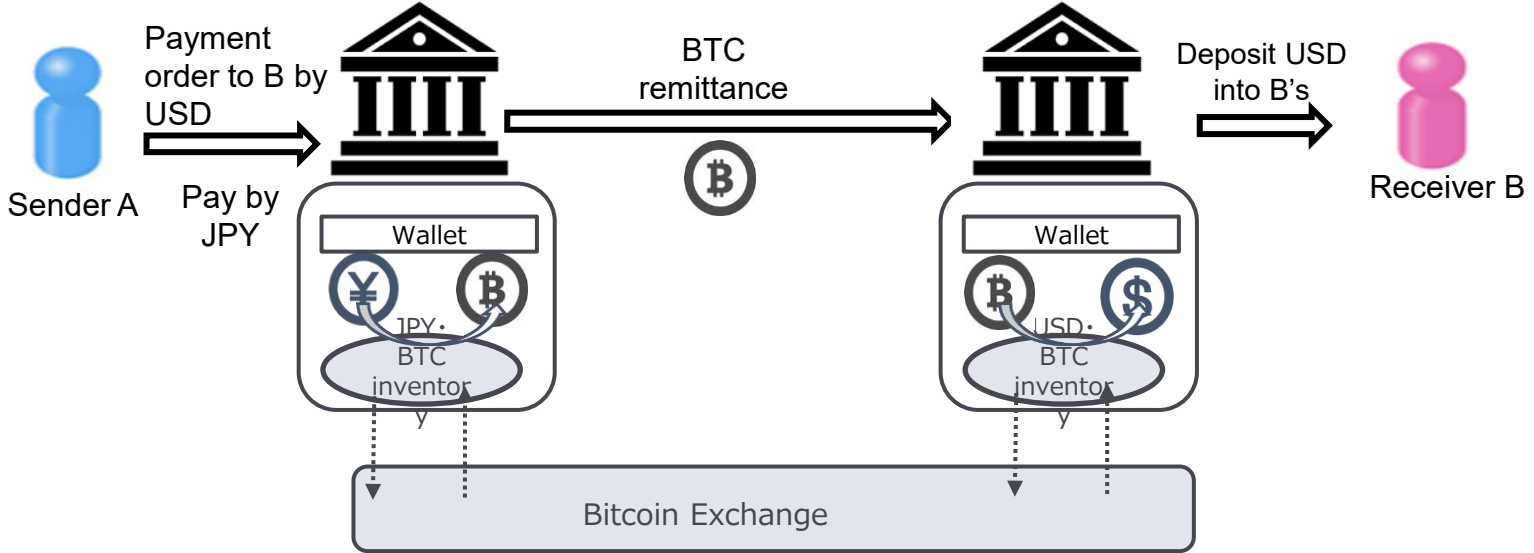
<Self-regulatory organization>

- ◆ VC Exchange Business providers may establish a self-regulatory organization, which is certified by the FSA:
 - FSA expects self-regulation to work to keep less governmental restrictions
 - Self-regulation will become important as a soft-law to be complied with by VC exchange business providers
- ◆ Alternative dispute resolution for VC exchange services to be handled by a certified self regulatory organization
- ◆ Certified self-regulatory organization to be formed in April

<Foreign VC exchange operators>

- ◆ Foreign VC exchange is eligible for registration only if it is licensed under its home jurisdiction
 - To be registered in Japan, foreign VC exchanger must have an office in Japan
 - To be registered in Japan, foreign VC exchanger must appoint a representative residing in Japan
 - Foreign VC exchanger may not engage in marketing activities toward Japanese residents unless registered in Japan
- So far, **most foreign exchanges attempt to set up a Japan subsidiary and obtain a license as Japanese company**
 - ✓ No restriction on foreign investment

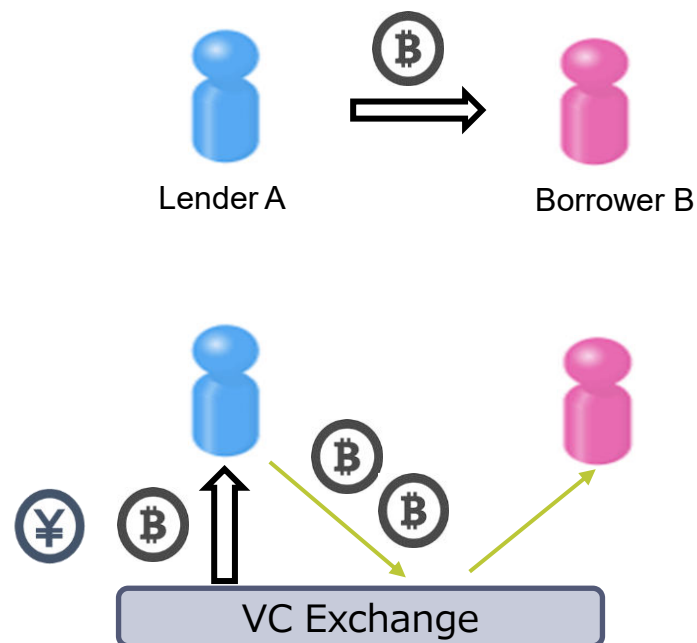
Transmitting VC is not a money transmission; money transmitting services using VC is regulated as money transmitting services



- ◆ Does this meet “Money Remittance” definition ?
 - ❑ Accepting an order from a customer to transfer funds by utilizing a mechanism that enables funds to be transferred without directly transporting cash with distant persons, or undertaking such transfer. (SCR 12.03.2001)
 - ❑ Bitcoin is not “money” (2015, cabinet decision)

- Merely sending VCs to a receiver is **NOT** “money remittance” because VC does not fall under “funds”
- **However**, it does meet “money remittance” definition if **VCs are utilized as a means of transferring funds** so that the **structure as a whole meets “money remittance” definition.**

Lending VC is not a money lending business; any attempt to get around money lending license not allowed



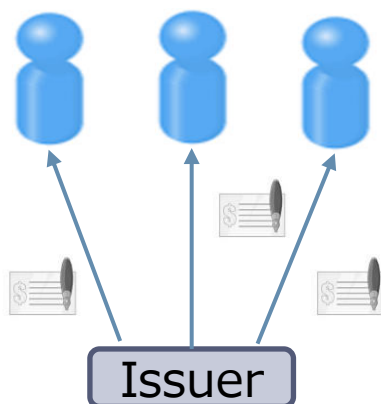
◆ Does this meet “Lending Business” definition ?

- ❑ Lending Business Act (Law# 32,1983), Art. 2, para. 1
“Lending Business” means lending money or acting as intermediary in lending money, which is undertaken as a business.
- ❑ Bitcoin is not “money” (2015, cabinet decision)



- Merely lending VCs to a borrower for business is **NOT** a “lending business”
- VC exchange must obtain lending business license to provide leverage transaction services for users if it makes a fiat currency loan, but does not need a lending business license if it makes a VC loan.
- In practice, VC lenders comply with certain consumer protection principles under Lending Business Act (such as maximum interest rate limitation of 15%)
- Any arrangement attempting to circumvent Lending Business Act is not allowed.
 - ✓ Providing bitcoin lending and exchange business at once so that a borrower gets fiat currency
 - ✓ Any other arrangement that meets borrower’s demand for fiat currency (i.e., partnering with VC exchange)

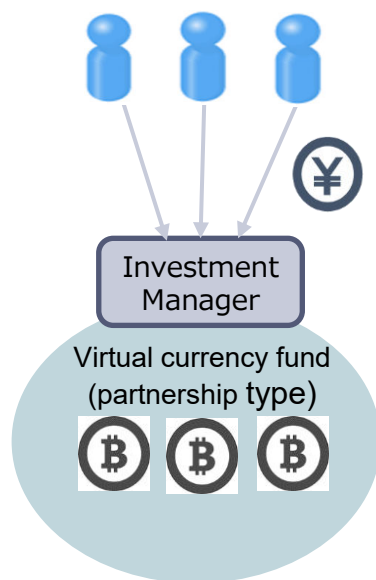
VC denominated corporate bond is not regulated under Companies Act or Financial Instruments and Exchange Act



- ◆ Does VC denominated corporate bond meet “corporate bond” definition ?
 - Does not meet “corporate bond” definition under the Corporations Law of Japan
 - (Probably) Does not meet “corporate bond” or “foreign corporate bond” definition under the Financial Instruments and Exchange Act of Japan
 - In practice, Issuers comply with principles of corporate bond rules under the Corporations Law and FIEA (such as disclosure, corporate governance etc.)

- ◆ Does an underwriting (or an arrangement) of VC denominated corporate bonds for others require securities license ?
 - No, because VC denominated corporate bond is not a “corporate bond” under FIEA

Forming a fund investing in VCs is regulated as Financial Instruments Service Provider; management of the fund could be regulated.



◆ Does this partnership unit meet “collective investment scheme (CIS)” under FIEA?

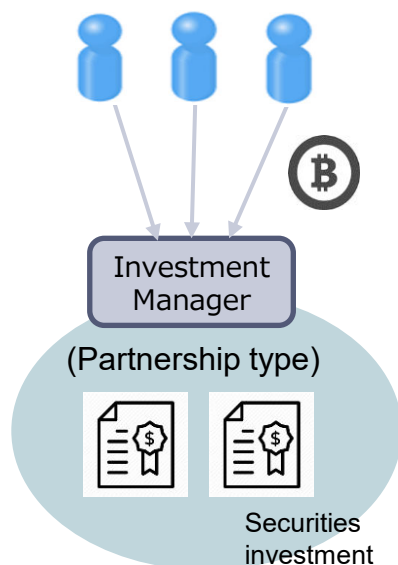
- A CIS arrangement must have all of the following elements:
 - (i) contribution of money or money equivalent listed in the Enforcement Order from investors;
 - (ii) business using the contributions; and
 - (iii) investors’ entitlement to the distribution of profits arising from the business or of assets relating to the business.



This does meet CIS under FIEA, so that

- ❑ Investment Manager (or intermediary) soliciting investment in the CIS must be registered as Type II Financial Instruments Services Provider under FIEA
- ❑ However, Investment Manager (or asset manager who undertakes fund management) does not need to be registered as Asset Management Service Provider under FIEA because Asset Management Service Provider license only concerns “financial instruments” under FIEA
 - ✓ Asset Management Service Provider license NOT required unless portfolio primarily consists of financial instruments
- ❑ FSA recently indicated cryptocurrency investment manager is required to be registered as Virtual Currency Exchange Service Provider

An investment fund with VC contribution is not CIS; any attempt to get around existing principles not allowed



◆ Does this partnership unit meet “collective investment scheme (CIS)” under FIEA?

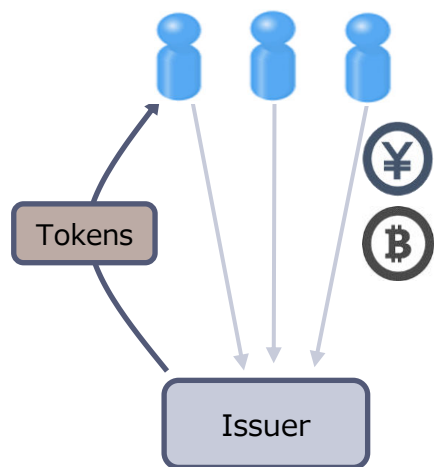
- A CIS arrangement must have all of the following elements:
 - (i) contribution of money or money equivalent listed in the Enforcement Order from investors;
 - (ii) business using the contributions; and
 - (iii) investors’ entitlement to the distribution of profits arising from the business or of assets relating to the business.
 - ❑ Elements (ii) and (iii) are met.
 - ❑ Is element (i) met ?
 - ✓ Currently, **VC is not listed as “money equivalent”** under the Enforcement Order
 - ✓ However, regulator points out you may not circumvent FIEA **by merely accepting VCs and undertakes asset management business that is identical to existing asset management business**
- * this might imply it is not CIS if the entire portfolio consists of VCs

- ◆ FSA recently issued a warning that **VC denominated fund could be regulated as CIS**

This most likely meets CIS, so that

- ❑ Investment Manager (or intermediary) soliciting investment in the CIS must be registered as Type II Financial Instruments Services Provider under FIEA
- ❑ Investment Manager (or asset manager who undertakes fund management) must be registered as Asset Management Service Provider under FIEA

Selling tokens that falls into CIS is not an ICO; it's just an IPO



- ✓ Product development and undertaking non-asset management business
- ✓ Tokens are structured so that **revenues are shared with token holders**

◆ Does these tokens meet “collective investment scheme (CIS)” under FIEA ?

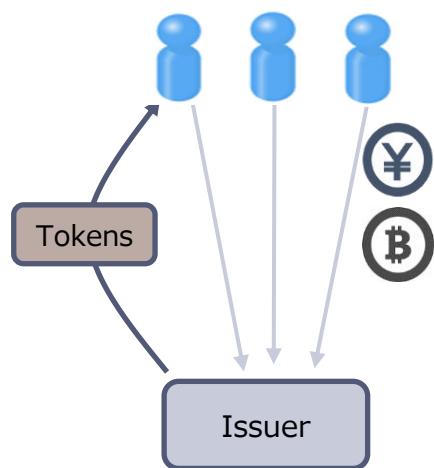
- A CIS arrangement must have all of the following elements:
 - (i) contribution of money or money equivalent listed in the Enforcement Order from investors;
 - (ii) business using the contributions; and
 - (iii) investors’ entitlement to the distribution of profits arising from the business or of assets relating to the business.
- ❑ As long as tokens have a “revenue share” feature, elements (ii) and (iii) are met.
- ❑ Is element (i) met ?
 - ✓ Currently, VC is not listed as “money equivalent” under the Enforcement Order
 - ✓ However, many practitioners point out you may not circumvent FIEA by merely accepting VCs , exchanging them into fiat currency, and undertaking business where the revenues are shared



These tokens most likely meet CIS, so that

- ❑ Issuer (or its intermediary) soliciting an offer to purchase tokens must be registered as Type II Financial Instruments Services Provider under FIEA
- ❑ An exchange service dealing with these tokens must be licensed as Financial Instruments Exchange

Tokens may not be designed as Prepaid Payment Instruments



- ✓ Product development and undertaking non-asset management business
- ✓ **Issuer's services are purchased by tokens**

- Both multi-purposes and single purpose PPIs are regulated under Japan's PSA.
- Issuer must deposit 50% of unused balance if tokens are PPIs
- No redemption allowed for PPIs
- Foreign issuer may not solicit an offer to purchase PPIs directly from overseas.

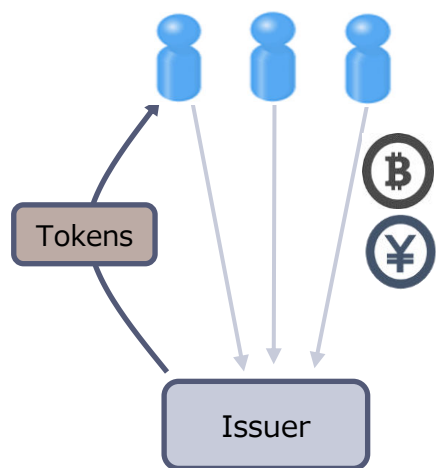
◆ Does these tokens meet "Prepaid Payment Instruments" under PSA?

- Prepaid Payment Instrument must have all of the following three elements:
 - ✓ **Record of Value.** The proprietary value of the instrument, such as monetary amount, must be recorded in certificates, electronic devices or other items ("Certificate") or in numbers, markings or other signs using electronic methods ("Electronic Sign"). Network type meets this element
 - ✓ **Issuance in Exchange for Consideration.** The Certificates or Electronic Signs must be issued in exchange for receiving any consideration corresponding to the money paid by the holder or the quantity of the goods or the value of the services that the holder is entitled to purchase.
 - ✓ **Use as Payment or Demand.** The Certificates or Electronic Signs must be presented or delivered as (x) a payment for goods or services provided by the issuer or a third party or (y) a demand for the provision of goods or services by the issuer or a third party.



- Utility tokens generally satisfies "Record of Value" element because this covers network type PPIs
- Utility tokens generally satisfies "Issuance in Exchange for Consideration" element because the term "consideration" widely includes anything that has a proprietary value.
- Utility tokens **should avoid satisfying "Use as Payment or Demand" element by designing tokens so that issuer is not obliged to accept tokens** for any of its services

Issuer must appoint licensed VC exchange service provider to conduct utility token sales toward Japan residents



- ✓ Product development and undertaking non-asset management business
- ✓ Tokens are either usage tokens or work tokens (i.e., no revenue share feature)

◆ Does these tokens meet “Virtual Currency” under PSA?

- Virtual Currency is an electronically recorded proprietary value other than legal currency and assets denominated in any legal currency, which either:
 - ✓ (a) can be used to pay to unspecified persons and can be sold to and purchased from unspecified persons and (b) is transferrable through an electronic network (“**Type I Virtual Currency**”); or
 - ✓ (x) is mutually exchangeable with a Type I Virtual Currency between unspecified persons and (y) is transferrable through an electronic network (“**Type II Virtual Currency**”).



On December 9, 2017, Japan Cryptocurrency Business Association, a voluntary self-regulatory organization for VC exchange service providers, released a guidance which states:

Utility tokens may be VCs unless they have implemented transfer restriction feature on a protocol level, whether or not the issuer implies future listing

<What this mean?>

- ✓ Token sellers must appoint a licensed VC exchange service provider to conduct an ICO, just like a company must appoint a broker/dealer to do an IPO; or
- ✓ Token sellers must put in place a transfer restriction feature on a protocol level which could be unlocked at the time of listing; or
- ✓ Exclude Japan residents.

Tax and accounting rules surrounding virtual currencies are being settled

<Tax>

- ❑ On July 1, 2017, the revised Consumption Tax Act designated virtual currencies as non-taxable assets
- ❑ In September 2017, National Tax Authority released a “tax answer” for income tax concern
 - Revenue generated from virtual currency is categorized as “other income”
- ❑ On December 1, National Tax Authority further released a detailed FAQs describing how to calculate income/revenue generated from virtual currencies

<Accounting>

- ❑ On March 14, 2018, Japan’s accounting standard setter, the Accounting Standard Board of Japan, resolved the new accounting standard entitled “Tentative Accounting Treatment on Virtual Currencies under the Payment Services Act of Japan”
 - Virtual currencies traded actively on the market are recorded at a market price
 - This standard does not cover ICO tokens

After the CoinCheck VC theft amounting US\$530MM, FSA tighten supervision over VC service providers

- ❑ 16 official licensed service providers and 15 grandfathering service providers as of Feb 2, 2018
- ❑ After CoinCheck, one of the grandfathering service providers, lost US\$530 million NEM on Jan 27, 2018, FSA started to tighten monitoring over VC service providers:
 - 10 providers received administrative order (improvement, suspension)
 - 5 grandfathering service providers withdrew application
 - 2 foreign exchanges blacklisted due to unauthorized offering of VCs toward Japanese residents
- ❑ “Study group on VC service providers” formed within FSA on April 10, 2018, of which all members are from non-crypto community, attempting to tighten the regulations including:
 - Leverage restriction
 - ICO restriction
- ❑ Currently, more than 100 applicants waiting in line to obtain license
 - FSA does not intend to limit the number of license, but all staff are taken up by on site monitoring (inspection)
 - Limited number of government officials is a bottleneck
- ❑ Tech-based industry turning to financial industry
 - Official self regulatory organization (SRO) expected to be lead by forex provider Money Partners
 - CoinCheck being acquired by securities broker Monex
 - Financial conglomerate SBI gaining power within VC industry
 - SRO to introduce capital requirement like securities industry

Going forward, a number of issues need to be overcome, but the principles will be eventually shared by local supervisory bodies

- ❑ From Japan’s perspective, very high-level issues include:
 - Whether VC industry should be merged into existing financial industry or ring-fenced ?
 - Whether banking group can deal with VCs ?
 - Should VC be regulated as security, commodity or other asset class ?
 - US aiming for security? commodity ?
 - UK aiming for commodity ?
 - Japan clearly aiming for other asset class
 - How ICO should be regulated ?
 - Which international standard setter hold jurisdiction over VCs ?
 - Currently FSB is responsible for putting together response to inquiry from G20
 - Is IOSCO best for taking on this role ?
 - Japan currently preparing to lead discussion for 2019 G20 Osaka Summit
- ❑ In addition to AML/CFT regulation, consumer protection principles must be shared among local supervisory bodies due to VC’s global feature:
 - **Market conduct principles** including insider trading and market manipulation regulation
 - **Prudential standard** applied for VC exchanges and brokers (and possibly segregation of assets)
 - **VC derivatives** regulation
 - **Fundraising activity** using crypto tokens
 - **Crypto Marketing** regulation
- ❑ More radically, should securities regulation be reformed to align with decentralized architecture ?
 - **Non-hierarchical** securities exchange architecture
 - Flat and network-based securities exchanges linking with each local exchange

Some frequently asked questions from overseas folks

- ❑ How long does it take to get a VC license ?
 - Normally 6 months, but currently takes more due to staff shortage
- ❑ Is ICO possible in Japan ?
 - Selling utility tokens to Japan residents typically requires VC license, regardless of the issuer jurisdiction
 - FSA takes a position that same rule applies to “airdropping” tokens, which is not reasonable
 - Issuer could issue tokens without license if it hires a licensed VC service provider who undertakes selling activities on behalf of issuer (just like broker/dealer who sells securities on behalf of issuer)
 - Currently some licensed VCs are negotiating with FSA to obtain permission for ICO broker business model, which will take another 3 to 4 months
 - As a result, new ICO is currently suspended in Japan
 - You could issue J-SAFT, or Japan version of Simple Agreement for Future Tokens, if you comply with securities regulation
 - To issue J-SAFT, issuer need to hire Type II Financial Instruments Service Provider
- ❑ What are the challenging parts to get a VC license, assuming I have enough money ?
 - Need to have a physical presence in Japan, including physical office space and a local representative (non Japanese national is OK as far as he/she is Japan resident)
 - Need to hire compliance, technology, and internal audit managers on a fulltime basis, no double (triple) hatting allowed for those three functions
 - Compliance person need to be knowledgeable about Japan’s financial regulations and how to get along with Japanese regulators
 - Need to hire accounting firm who is in charge of accounting auditing and auditing segregation of assets compliance
 - You cannot outsource all the application process to lawyers; business persons must sit in front of the regulator and responsible for answer questions, lawyers will support for it
 - Ground-level application reviewers typically do not speak English

Thank you!

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